Value focus

MAXIMIZING THE BENEFITS FROM THE SALE OF YOUR BUSINESS

You have spent years building your company and it is probably your most valuable financial asset. Like your family, that effort has given meaning to your life. It would be unfortunate if you did not receive the fullest possible reward for you and your family from a sale of your business. Yet, that is the most likely result.

We have found that business owners and their advisors often fail to implement **presale** strategies that can enhance the personal and financial benefits from a future sale. Then, at the time of sale, the effort is focused too strongly on sales price and deal terms, resulting in additional missed opportunities.

In this article we will share some of the insights we have gained from 40 years of consulting to entrepreneurs.

We hope they will help you maximize the benefits you receive from a sale of your company, whenever that might be.

What is Important to You?

Here are some questions you should ask as you contemplate a current or future sale of your business.

★ What is the market value of my company?

★ Are current industry and market conditions favorable to a sale and, if not, should I defer selling until conditions improve?

★ What can I do in the next two to five years to improve the value of my company?

★ Who are potential buyers and do I have a preference or choice?

★ Who do I want to benefit from the sale and to what degree? (Family, employees, charity and state and federal governments are all potential current and future beneficiaries of a sale.)

★ Should I consider a partial sale and how can I do that?

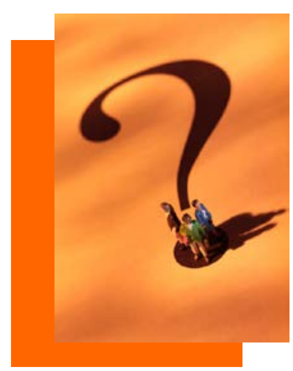
★ Will the after tax sale proceeds provide financial security for me and my spouse for the rest of our lives?

★ What deal structure will most help me meet the objectives I have established for me and my family?

★ If substantial wealth will result from the sale, how can I address the potential negative impact this wealth could have on my children or grandchildren?

★ What can I do to minimize the income tax bite from a sale?

★ What can I do to reduce potential estate taxes?



Baldwin & Clarke Advisory Services, Inc.
Investment Advisory and Wealth Transfer Planning

A Few Caveats

The following discussion will touch on certain income and estate tax planning concepts; however, **Baldwin & Clarke Advisory Services, Inc. (B&CAS)** does not provide legal or tax advice. Your tax and legal advisors should be consulted.

We will reference specific tools that can help develop answers to some of the above questions. Given the limited scope of this article, we will focus on the benefits these tools offer more so than their inner workings.

Financial Security

When you sell your business you give up the salary, bonuses, dividends and perks you currently enjoy. Presumably, you would like the invested after tax sale proceeds to provide an income stream that would allow you and your spouse to at least maintain your current lifestyle for the rest of your lives. Will that be possible?

This is a classic "chicken and egg" question. Do you determine your income objectives and then measure the required investment capital against the potential after tax sales value of your company, or do you begin with an estimate of the sales proceeds and then determine what income they will provide?

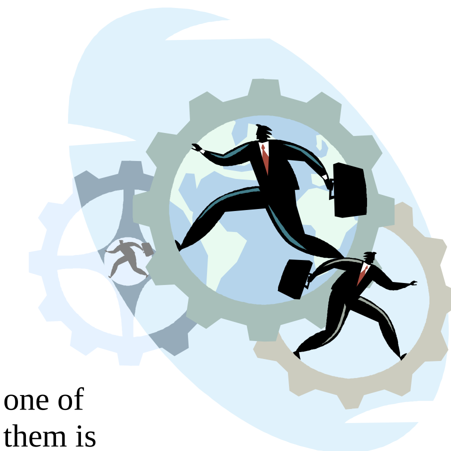
Let's assume you choose the former approach. Are you willing to (or must you) consume capital to meet your income requirements, or do you prefer to preserve capital for ultimate distribution to heirs? What about a combination of these approaches?

The B&CAS **Retirement Actuator** can calculate the amount of capital necessary to meet your financial security objectives based upon which of the above alternatives you choose. Ideally, this analysis should be done years before a sale is contemplated to enable the implementation of business and financial planning strategies that will help ensure that your financial security objectives will be met. However it is never too late. If you are planning to sell tomorrow, this analysis will be helpful – perhaps even critical.

The two major retirement risks are

- ★ living too long; and
- ★ inflation

Both can erode principal. The Retirement Actuator calculates the statistical life expectancy of you and your spouse, collectively and individually. Keep in mind that your life expectancy is that age at which one half of the people your age are expected to die. The other half will still be alive! A 65 year old couple has a statistical life expectancy of approximately 28 years, that is,



one of them is expected to live at least that long. Given today's advances in health care and medicine, your financial security planning time horizon should probably extend to age one hundred.

After you set an annual retirement income objective expressed in today's dollars, the Retirement Actuator projects this requirement on an annual basis to adjust for inflation. For example, it would require an income of $541,800 in 20 years to equal the buying power of $300,000 in today's dollars, assuming a three percent inflation rate. The analysis can factor in other considerations. For example, do you think your retirement income needs will vary as you move through time, e.g., will you spend more for travel in the early years?

The next step determines the amount of capital and investment strategy required to meet your lifetime income objective. Your investment portfolio will need to generate current income ***and*** grow so that future income can keep pace with inflation. As an aside, you can invest in income producing securities or employ a "total return" asset management approach to meet income and growth requirements. With this latter strategy, you withdraw a percentage of your portfolio to meet income needs each year. The withdrawn funds can come from interest, dividends or realized capital gains as long as the total return, on average, is sufficient to support the withdrawals and grow to meet inflation.

The Retirement Actuator's asset allocation analysis determines the asset allocation strategy best suited to your objectives. This analysis takes into account your tax bracket, your emotional and financial tolerance for risk, your time horizon, your income requirements, your attitude toward capital preservation for heirs and your asset class preferences.

The above factors are then combined with risk and return estimates for several asset classes and data as to how the returns of these asset classes correlate with each other. This combined information is used to develop an optimized portfolio structure, specific to your needs. (An optimal portfolio maximizes the expected return for the level of investment risk you are willing to assume.)

The bottom line: You will know, with a reasonable degree of certainty, the amount of capital and portfolio strategy required for your lifetime security.

You can then compare this capital requirement to the anticipated after tax proceeds from a sale of your company.

By portfolio structure, we mean the percentage of your portfolio that should be allocated to each of several asset classes.

Once the expected return from the optimized portfolio is established, we can determine the amount of capital required to meet your projected after tax lifetime income needs. A probability analysis measures the likelihood of achieving the targeted rate of return.

The bottom line: You will know, with a reasonable degree of certainty, the amount of capital and portfolio strategy required for your lifetime security.

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If estimated sales proceeds are insufficient, you may want to defer a sale and incorporate business strategies that will grow business value. You can also use tax favored approaches in the years prior to a sale to build an outside portfolio, develop business real estate strategies that add to retirement income, and so on. You can also implement asset protection planning to minimize the risk of loss of business and personal assets from lawsuits and creditors.

Financial Products

An often overlooked aspect of planning for retirement security is the role that can be played by properly integrated financial products. (B&CAS does not sell financial products.) Here are a few of the more obvious product planning opportunities.

- ★ If your retirement income needs will require the consumption of some of your principal, you can allocate one or two percent of your portfolio value to the purchase of a second to die **life insurance policy** that will replenish your estate for your children and grandchildren. This money can be received by them on an income and estate tax free basis.
- ★ **Annuities** can provide an income stream that you and your spouse can never outlive.
- ★ **Long term care insurance** can protect against the significant drain on capital that could result from an extended period of home health, assisted living or nursing home care.

What is My Business Worth?

Your business has an “intrinsic” value and a “market” value. The intrinsic value is its stand alone value. The market value is what you can reasonably expect a buyer to pay for your company. These two values can vary widely.

The intrinsic value can be objectively determined by a business valuation professional. It is the value that is supported by your company’s historic and projected financial performance and capital structure. To arrive at this value, the appraiser would recast your financial statements by making adjustments that would “normalize” historical performance. A typical adjustment would be to increase earnings by the amount of excess compensation taken by a business owner relative to what might have been paid to a professional manager.

All other things being equal, the intrinsic value of a business would be a good estimate of its market value. But all things are seldom equal. You need the services of an investment banking firm to best estimate your company’s potential market value.

If the investment banking firm also performs the “intrinsic” valuation, certain cost efficiencies could result as the appraiser would examine some of the factors that impact market value during the initial valuation process.

An investment banker will seek to identify the buyer(s) who will most likely pay the most for your business. This requires a thorough knowledge of your industry, your company’s place in it and recent industry M&A activity. He or she can tell you if the market for businesses like yours is hot or cold. If it’s hot, a buyer may pay a significant premium over intrinsic value. This is often the case when an industry is going through a “roll up” stage.

Your business may be of significant value to a specific buyer because it provides access to a geographic or product market of strategic importance. The value of your company to a particular buyer may also be higher than its stand alone intrinsic value due to potential operating synergies.

Some industries are made up of so many companies that their market prices have been commoditized – reduced to a simple formula for example, and the best of investment bankers would be unable to find an industry player that would pay a premium. In those cases, the best buyer might be found outside of the industry.

The value of your company to a particular buyer may also be higher than its stand alone intrinsic value due to potential operating synergies.

The Most Common Mistakes When Selling a Business

1. Failure to do presale planning. This topic is addressed throughout this article and we will not add to those comments here.

2. Selling at the buyer's price. You will sell your business only once. The buyer has most likely bought several companies. Who do you think has the negotiating advantage in that environment?

We mentioned a few examples of how a premium price might be obtained, but buyers don't walk in and offer premium prices. In fact, if a buyer contacts you first, you can almost bet that the offering price will be below even the intrinsic value of your company. For starters, the buyer will work off of your reported financials, which reflect all the tax planning strategies that you have used over the years to reduce reported earnings. Buyers that approach sellers often have a "rubber stamp" approach to pricing. They know what they have persuaded others to take and have, in their minds, "set" the market. They certainly try to convince potential sellers that they have.

> Negotiating a deal on your own is akin to a doctor performing surgery on himself.

To avoid this mistake, you need an experienced investment banker on your side. This is true if you ***or*** a potential buyer has initiated the process. Negotiating a deal on your own is akin to a doctor performing surgery on himself. An investment banker's fee is likely to be covered several times over by the added dollars you receive as the result of his or her involvement. Baldwin & Clarke Corporate Finance, for example, has had considerable success in identifying the best strategic buyer for its clients, often securing premium prices.

3. Failure to negotiate the purchase price details. A buyer will sign a letter of intent, which stipulates a potential purchase price prior to conducting its due diligence. The due diligence process often leads to price adjustments. A good investment banker should work through this phase of the negotiations on behalf of the seller to ensure that any proposed price adjustments are reasonable, proper or avoidable. In some cases, upward price adjustments can be negotiated at this stage.

4. Failure to structure the most favorable terms. Favorable is a relative thing. What is favorable to one person or in one set of circumstances may not be to another person or situation.

Should you take your payment in cash, stock or a combination, in a lump sum or installments? These are the basic terms that need to be negotiated. Will there be an "earn-out" component that can adjust the purchase price based on future events? What you want and what the buyers willing to offer, may also be very different. You need a framework in which to analyze the options available to you.

B&CAS has that framework. It begins with the Retirement Actuator described above. Your income needs and risk tolerance levels all come into play. Working with your tax advisor we can assess the tax implications of the various options. If you are going to take back paper, you need to determine the credit worthiness of the buyer. If you are considering stock as a partial or full payment, you need to analyze the stock risk and develop an assessment of future stock performance. How would the stock holdings impact the risk/return tradeoff of your post sale portfolio and the probability of meeting your lifetime income objective?

If you do take stock, there will likely be restrictions on your near term ability to sell those shares. You can mitigate future stock price risk by instituting a hedging strategy that will set a floor price for the stock at the expense of giving up some of the upside potential. This and other possible risk modification strategies, certain charitable trusts (discussed below), for example, should be examined before you finalize a transaction.

Stock, cash, notes, or a combination thereof: which is most likely to maximize your potential benefits? Probability and present value studies can help you evaluate and compare the expected economic benefits possible from various structures. Once you decide which sale terms best suit your needs, you will have a basis for evaluating competing offers and your investment banker will be better equipped to negotiate on your behalf

There are more esoteric components of a deal structure that are almost never considered by investment bankers.

*A seller may be willing to **sweeten the pot** if a portion of the sales price can be paid through the purchase of an annuity that will guarantee lifetime income to the seller, or the seller and buyer can become partners in a preferred interest LLC which will enable a seller to ultimately recover a portion of its purchase price and the seller to receive a tax free stream of income commencing at a specified future date. These and other techniques can improve the present value of after tax benefits to a seller.*

All of these issues highlight the need for a financial planner as a part of a business sale team.

5. Selling (or not) at the wrong time.

There are times when a business must be sold. Death, illness, bankruptcy and inadequate business succession planning are common causes of forced sales. But there are also times when business owners simply make poor timing decisions.

We have experienced more than one situation in which a business owner elected not to sell because he couldn't get "his" price even though the presale feasibility study clearly demonstrated that their was little or no chance for the company's value to increase. The future bore out the conclusions of the studies.

We have seen owners elect to sell into a soft market, simply because an offer was on the table, even though there was evidence to suggest that market conditions were likely to improve within a few years.

A proper feasibility study will not only assess current market conditions, but also determine those factors which drive a company's value. Growing free cash flow usually increase value. In some instances this can be accomplished by growing sales, in others sales growth will have the opposite effect. Lowering costs, increasing the working capital turnover rate, improving margins, changes in capital structure are all possible value drivers. The business valuation model will estimate the potential value increase that could result from various operational strategies. Therefore, it often makes sense for a client to grow value and defer a sale for three to five years.

An investment banker with a client centered, as opposed to transaction, focus will help a business owner assess all of the factors that impact the timing decision.

The model might also conclude that the business owner cannot increase value because of various constraints – usually capital. But if the value drivers are clearly understood, a potential buying company might be persuaded to increase its offering price because it can't pass up the future value opportunity that could result from the addition of its capital to the enterprise. This is but one kind of synergy that an investment banker can identify and exploit for a seller when searching out and negotiating with potential buyers.

Presale Estate Planning Opportunities

If a gift and estate tax free wealth transfer to your children, or trusts for their benefit, interests you, there are strategies that should be considered before you sell your company.

★ *Grantor Retained Annuity Trust*

Primary among these is a grantor retained annuity trust, or GRAT. GRAT planning allows you to take advantage of valuation discounts and to shift asset growth to your children.

A fractional interest in a business is worth something less than its proportionate share of the company's total value. For gift and estate tax purposes, stock is valued at its "fair market value" (the price that a willing buyer would pay a willing seller if neither was under undue pressure to buy or sell). An appraiser would typically assign a 30 to 50 percent lack of control and marketability discount to a block of minority stock.

Assume that the intrinsic, full enterprise equity value of your business is $30 million and you want to shift one-third of your stock to your children. If a 40% discount was applied to a one-third block of your company's stock, its value would be $6 million.

A grantor retained annuity trust is what it sounds like. It is a trust created by a grantor – the person who gifts assets to it (you). The grantor retains the right to receive annuity payments from the trust for the duration of the trust term. The annuity payments must be equal to the value of the assets given to the trust, plus interest at a rate determined by the US Treasury. At the end of the trust term, remaining trust assets are distributed to beneficiaries.

Here is a simplified (read not technically accurate) example of how a GRAT might work. Let us assume you transfer one-third of your stock to a GRAT with a five year term and the discounted stock value is $6 million. For gift tax purposes, the value of your gift would be "zeroed out", that is cancelled by the present value of your annuity payments. Assuming a GRAT interest rate of five percent, you will receive total annuity payments (in the form of stock) over the term of the GRAT of $7,500,000. (GRATs require an annual business valuation to determine the number of shares which must be distributed to meet the required annuity payments.) Assume further that your stock value grows by more than five percent per year so that the stock remaining in the trust at the end of five years is valued at $1.5 million. This remaining stock will be transferred tax free to your children.

If your company was sold for $30,000,000 before any annuity payments were made, the GRAT would have received $10,000,000 for its stock. Assuming no growth on the invested stock proceeds received by the GRAT, $3,500,000 would be distributed tax free to your heirs at the end of the trust's five year term.

It would not be unusual for an appraiser to develop a conservative estimate of a company's enterprise or intrinsic value for gift and estate tax purposes. Imagine the results in the above example if the business was actually sold for $50,000,000. <u>We have seen that kind of event.</u>

In the case of Subchapter S corporations with substantial dividend paying capacity, we have established GRATS that have made most or all of the required annuity payments in cash.

In some cases, tens of millions of dollars have been transferred without gift or estate taxes!

★ Charitable Remainder Trust

Many entrepreneurs wish to leave a ***charitable legacy***. If you are among them, you will want to explore the possible use of a charitable remainder trust (CRT) before a sale event. A charitable remainder trust is somewhat like a GRAT in that it makes annual income payments to the donor – possibly for life. At the donor's death, the remaining trust assets are transferred to charity free of trust. But a CRT has tax advantages not available with a GRAT.

Assume you take the buying company's publicly traded stock as a portion of your sale proceeds. If the shares are unrestricted, you could sell them and have the ***after tax*** proceeds available to invest. However, you may be reluctant to sell the stock because of the added capital gain tax burden. But if you don't sell, you will be exposed to excessive market risk.

You can resolve this dilemma by transferring the stock to a charitable remainder uni-trust (CRUT). The CRUT would pay you a fixed percentage of the market value of its assets each year. Because the trust is a charitable entity, it can sell the stock without any capital gains tax and invest the ***tax free*** proceeds in a diversified portfolio. You benefit from diversification and a higher stream of income. In the year you transfer the stock, you also enjoy an income tax deduction equal to the present value of the charity's expected remainder interest.

You can transfer stock in your closely held company to a net income make up charitable uni-trust (NIMCRUT), before a sale. If the assets of a NIMCRUT do not produce income, the income payments are deferred and "made up" (with certain restrictions) until income is available. A NIMCRUT can also have a "flip" feature which turns income payments on when the donor reaches a certain age or when a specified event (like the sale of the donor's business) occurs. The potential income payouts from a NIMCRUT can be substantial and, given enough time, can be one of the most advantageous strategies for maximizing the benefits from a business sale.

B&CAS has modeled potential wealth outcomes from the no CRUT vs. CRUT options, and it is possible for either one of the CRUT approaches to maximize a seller's wealth over time and result in a significant charitable legacy. Incidentally, a family foundation can be the ultimate beneficiary of a CRUT.

★ Qualified Retirement Plans

You may have a considerable amount of assets in qualified retirement plans ***(profit sharing, 401k's, IRA's)***. Most people highly value these retirement plans dollars and rightly so. However, for high net worth business owners these dollars may truly be called "junk money" as they are potentially subject to estate and income taxes at death. As a result, they may be worth as little as 20 or 30 cents on the dollar to heirs.

If it is clear that you won't need these assets for your retirement, you can use them to implement pre or post sale insurance based strategies that will substantially multiply their value for your children and grandchildren.

★ *Empowered Wealth Planning*

If you are concerned about the negative impact that ***inherited wealth*** may have on your children and future generations, you should consider Empowered Wealth planning.

The Empowered Wealth System (EWS) enables wealth to be transferred with accountability and stewardship, thus assuring that it will empower your heirs, not weaken them. The EWS also identifies a family's True Wealth (the sum of its human, intellectual, financial and civic assets) and establishes a Family Co-operative designed to capture and transfer this True Wealth for the empowerment of future generations. The Family Co-operative structure encourages all family members, present and future, to add to the family's store of True Wealth.

B&CAS can help you determine if Empowered Wealth planning is appropriate for you and your family.

A Partial Liquidity Event Opportunity

Earlier, we mentioned that employees are potential beneficiaries of a company sale. While we won't discuss them here, there are phantom stock, deferred compensation, stock bonus and other arrangements which can bring about this result. For purposes of this article, we will focus solely on employee stock ownership plans (**ESOP's**) as they also offer a "C corp" business owner the opportunity for a tax advantaged partial liquidity event.

A business owner can sell some of his closely held stock (it must be at least 30%) to an ESOP and defer the capital gain if he timely invests the proceeds in what the Internal Revenue Code calls "qualified replacement property". The gain is deferred until the replacement property is sold.

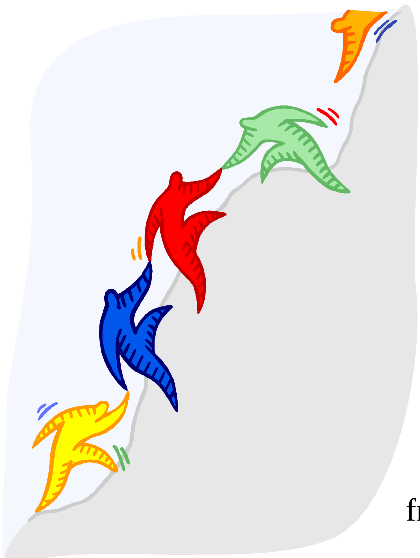
There are many reasons why you might consider an ESOP transaction. One may be to diversify risk. As noted at the outset, most of your wealth is

likely tied up in your business. Another would be to create an alternate income stream as you "wind down" your day to day business activities. You may see a partial ESOP sale as a way to cash out so that your remaining business interest can be transferred to your children via your estate plan.

No matter the motivation, considerable analysis will be required. The Retirement Actuator process described earlier could help you determine if an ESOP transaction would provide for your long term financial security. But that is only a beginning. For example, diversification may not be as easy as it sounds. The preferred (to meet qualification requirements) qualified replacement assets are long term floating rate notes. These are issued by only a few US corporations. To further diversify into a portfolio of stocks and bonds you would have to borrow against the notes. The Retirement

Actuator analysis would need to factor in the impact of borrowing costs, if you wished to consider this diversification approach. The analysis would also help you determine how much of your ownership to sell.

Additionally, an ESOP has corporate finance implications which should be analyzed as the purchase funding mechanism will impact the company. An annual business valuation will also be required.



Conclusion

A business sale is, for most entrepreneurs, a once in a lifetime event. The pitfalls are many. **Most business sellers unwittingly miss significant planning opportunities and leave far too many dollars in the buyer's pocket and the IRS's coffers.** To avoid these mistakes, surround yourself with a strong advisory team made up of a qualified investment banker (not a business broker), a financial planner who is well versed in advanced estate and financial planning as well as asset allocation modeling and, very importantly, your tax attorney, corporate counsel and accountant.

A final few words: It is never too early to plan for maximizing the benefits from a sale of your business.

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